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Financial Sector Supervision in Ukraine: Would an Integrated Supervisor Help?

Executive Summary

Following international trends to integrate financial sector supervision authorities, Ukraine considers the possibility of integrating two supervisory authorities, the State Commission for the Regulation of Financial Markets and the State Commission for Securities and the Stock Market. While we agree in principle that an integration of supervision has some appeal, we do not expect any positive effect in the case of Ukraine. The most pressing problems of financial sector supervision in Ukraine, namely the lack of qualified employees, the lack of appropriate capital goods, the lack of political support for supervisors and a frequently varying institutional framework of supervision, will not be solved. On the contrary, some of these problems will increase. In fact, we expect a significant worsening of financial sector supervision. Consequently, we strongly advise the Ukrainian Government to postpone the plans to integrate the two commissions until the most pressing problems of financial sector supervision are solved.

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1. Introduction

There is a broad consensus that prudential financial supervision is a major requirement for a stable and efficient financial sector. Over the last years, a number of countries have decided to move towards an integration of their financial market supervision authorities. Major driving forces behind these developments are the increasing role of financial conglomerates with activities in different financial industries.

This discussion has also been held in Ukraine. The Cabinet of Ministers' Programme "Towards the Needs of People" adopted by the Tymoshenko Government envisioned an element of integration of the different financial sector supervision authorities in Ukraine. By unifying two commissions – the commission for the insurance market and the commission for the stock market – the supervision of financial markets in Ukraine was intended to be improved. The former Minister of Economy Mr. Teriohin also proposed to create an integrated supervisor for financial markets. However, the proposals did not meet enthusiasm on the side of market participants and the affected commissions. Many, amongst them the League of Insurance Organisations, the Commission for the Regulation of Financial Markets, and the Commission for Securities, agreed that a unified supervisor might be reasonable in the long-run. But creating a single authority at this stage was not considered as opportune by everyone. Some even fear that integrating the authorities might harm the development of the Ukrainian financial sector. For example, the Minister of Finance, Mr Pynzenyk, called for a postponement of integration for an undefined period. But notwithstanding this declaration, the new government under Prime Minister Yehanurov is likely to reconsider plans for the integration of financial supervisors.

As explained in more detail below, we believe that financial sector supervision in Ukraine faces a number of very serious problems. In view of these urgent problems, the discussion on the integration of financial supervisors looks rather misplaced and artificial.

But as the debate has already been opened, this paper shall contribute to the discussion by analysing the impact integration would have on the most pressing problems of financial supervision in Ukraine.

This policy paper is structured as follows. Part 2 of this paper discusses the general rationale for and against an integrated financial supervisor. The third part identifies the main problems of the current financial supervision in Ukraine. Part 4 analyses the likely effects integration would have by taking country specifics into consideration. Concluding, Part 5 provides policy recommendations.

2. The rationale for and against an integrated financial sector supervision

Before analysing the suitability of an integrated agency for Ukraine, the subsequent paragraphs will outline those advantages and disadvantages of such an agency regularly mentioned in the economic literature and shall describe international experiences with integrated supervisors.

2.1. Benefits

The following benefits are attributed to an integrated supervisor and have led to several countries moving towards this form of organising financial sector supervision:

i) Enablement of financial conglomerate supervision

Financial conglomerates have recently gained importance. Their diverse activities require that the risk of the group to be assessed on a consolidated basis. An integrated supervisor can ensure supervision free of gaps.

ii) Competitive neutrality

The boundaries between financial products and services have increasingly blurred. Banks, insurance and securities firms compete in the same market for the same customer. Different regulations or requirements of information may lead to comparative advantages for one industry. An integrated supervisor may prevent regulatory arbitrage and ensure a level playing field.

iii) Regulatory flexibility

An integrated regulatory agency is likely to adapt faster to new challenges (development of new financial products or financial institutions). If multiple specialised supervisors exist, doubts about jurisdiction or rivalry may prevent effective ways of response.

iv) Enhancement of efficiency (economies of scale)

Creating an integrated authority can reduce operating costs. This was one of the strongest arguments for small economies or countries with small financial sectors to unify their agencies. In addition, communicating and sharing relevant information is easier, especially when co-operating internationally.

v) Improvement of accountability

The existence of multiple supervisors can lead to difficulties in holding the regulators to account for their performance, as overlapping responsibilities make it possible to blame the other supervisor for one's own failures, thus making it difficult to hold any of the supervisors responsible. However, this argument is not particularly strong as it does not hold if the individual supervisor's objectives are clearly specified.

It should be mentioned, that the benefits are considered to be largest when banking and insurance supervisors join. Convergence of financial intermediaries (for example at the distributional level) is highest between banks and insurers, this being the reason why the French term "bancassurance" is often used to describe these linkages. Germany's largest financial conglomerate – Allianz AG – emerged when the insurer Allianz acquired Dresdner Bank AG.

2.2 Drawbacks

Integrating supervision authorities can also have major drawbacks:

i) Unclear objectives

An integrated authority may have trouble balancing between the different objectives of regulation and might not be able to adequately differentiate between different types of institutions. Occasionally conflicts of interest may arise.

ii) Diseconomies of scale

The integration may also lead to an agency that is effectively a regulatory monopoly. This might cause a rise of inefficiencies. For example, a monopoly supervisor may be more rigid and bureaucratic than separate agencies.

iii) Regulatory capture

Creating a single integrated supervisor could facilitate corruption for market participants operating in different sectors. After all, bribing many supervisors can be more difficult than bribing only one.

iv) Creation of a "Leviathan"

Creating a large and powerful integrated supervisor may lead to the development of a "mighty bully, a bureaucratic leviathan divorced from the industry it regulates".

v) Limited synergies

Some argue that synergy gains are not very large. For example, risks for banks are on the asset side while those of insurances are on the liabilities side.

vi) Moral hazard

The public may assume that all financial institutions will be granted similar protection after integration. Without integration, the perception is more differentiated. This argument against integration is particularly troublesome if all authorities are united within a nation's central bank, as this institution may have bailed out or is perceived to be willing to support troubled banks.

Box 1
International experiences with integrating supervision authorities

Integrated financial supervision was first installed in Scandinavia. Norway established the first integrated supervisor in 1986, followed by Denmark and Sweden in 1988 and 1991. Since then a number of countries have followed suit, amongst them a number of European countries. Next to the United Kingdom, some of the new EU member states have also created consolidated supervisors at the end of the last decade. Germany followed in 2002.

The overall experience is positive. None of those countries that have established an integrated agency have faced a noteworthy discussion to disintegrate the agency.

However, a tendency to have been assigned additional tasks even though this may distract from the original function has arisen in some countries (occasionally labelled as the "Christmas-tree effect"). For example, some integrated authorities have been assigned to also regulate real-estate brokers. It is less likely that these would have been assigned to traditional specialised supervisors.

An international survey conducted by the World Bank in 2003 indicates that the overall positive experience crucially depends on a comprehensive plan and strong managerial skills within the new agency. It is important to note, too, that integrated supervision is a very recent phenomenon. Its long-term effectiveness still remains to be proven.

Table 1
Fully or partially integrated financial supervisors in Selected European Countries*

Country	Name of Agency	Year of Establishment	Intermediaries supervised by the agency
Austria	Finanzmarktaufsicht (FMA)	2002	Banks, Securities, Insurance, other NBFIs[1]
Denmark	Danish Financial Supervisory Authority (FINANSTILSYNET)	1988	Banking, Securities, Insurance, other NBFIs
Estonia	Financial Supervision Authority (FSA)	1999	Banking, Securities, Insurance, other NBFIs
Germany	Bundesanstalt für Finanzdienstleistungs-aufsicht (BaFin)	2002	Banking, Securities, Insurance, other NBFIs
Hungary	Hungarian Financial Supervision Authority (HFSA)	2000	Banking, Securities, Insurance, other NBFIs
Latvia	Financial and Capital Market Commission	1998	Banking, Securities, Insurance, other NBFIs
Luxembourg	Commission de Surveillance du Secteur Financier	1999	Banking, Securities
Malta	Malta Financial Services Centre	2002	Banking, Securities, Insurance, other NBFIs
Norway	Kredittilsynet	1986	Banking, Securities, Insurance, other NBFIs
Slovakia	Financial Market Authority (FMA)	2002	Securities, Insurance
Sweden	Finansinspektionen	1990	Banking, Securities, Insurance, other NBFIs
United Kingdom	Financial Supervision Authority (FSA)	1997	Banking, Securities, Insurance, other NBFIs

* Comprises agencies supervising at least two types of financial intermediaries.
Source: José de Luna Martinez and Thomas A. Rose, International Survey of Integrated Financial Sector Supervision, World Bank Policy Research Paper 3096, July 2003; national agencies websites.

3. Ukrainian financial supervision and its problems

The prudential regulation and supervision of financial institutions in Ukraine is executed by separate state bodies responsible for regulation: The National Bank of Ukraine regulates commercial banks; the State Commission for Regulation of Financial Services Markets (hereafter – the Financial Services Commission) – the insurance market, non-state pension funds, crediting institutions (credit unions, leasing companies) and financial companies; the State Commission for Securities and Stock Market (hereafter – the Securities Commission) – all capital markets participants. In this paper we focus mainly on the activities of the two commissions, which perform regulation over non-banking institutions, since the discussion regarding the prospects for the creation of an integrated financial supervisory authority over Ukraine's financial market concerns exactly these two organs.

The Financial Services Commission is a very young and inexperienced institution. It was created in late 2002 soon after the Law of Ukraine on Financial Services and Regulation of Financial Markets was adopted. The Financial Services Commission unites the Head of

[1] NBFI refers to non-bank financial institutions.

the commission, three Deputies of the Head and at least three commission’s members – usually the Heads of the departments. The decisions are reached based on the collective voting with each voter provided equally with one voice. The President of Ukraine appoints the Head and the members; however, the Head is personally responsible for all the decisions adopted by the commission. As of January 1st 2005 238 people were employed in the Financial Services Commission, 177 of which worked for the central office. Most of the employees have completed economic education (almost 60%); others received juridical and humanitarian degrees (30%). The only source of finances for the commission’s activity is State Budget funding.

The Financial Services Commission sharply lacks political and financial support required to fulfil its important monitoring tasks. At present, it does not even have the necessary resources to set up a basic IT-based record of insurers’ capital movements. Its Head is unable to hire and train insurance experts at competitive salaries leading to high turnover of its employees: people start working in the commission, learn specifics of the financial services markets and then leave for positions in the private sector. It also lacks the political power to withdraw licenses or force mergers and takeovers if financing or management is insufficient. The lack of state support for the commission leads to the execution of its supervisory assignment in a very difficult environment.

Very similar problems relate to the regulator over the stock market in Ukraine – the Securities Commission, which was created in 1995. The Securities Commission has 26 local offices and one central office. It employed more than 600 people at end of 2004, 98% of which have completed higher education. The only source of finances for the commission’s activity is State Budget funding. Inadequate funding has become a particularly acute problem in recent years. Its hardware and software, to a greater extent introduced just after its creation, have completely depreciated. The need to create a unique modern informational system is particularly pressing. Without sufficient financing and political will the ability of the Securities Commission to exert effective supervision becomes questionable.

From all the above mentioned, the major problems impeding the development of adequate financial supervision in Ukraine are the following:

1. A lack of qualified employees and low level of salaries;
2. A lack of appropriate capital goods (especially software);
3. A lack of political support from the Parliament and questionable true independence of the regulative activities;
4. A frequently varying institutional framework of supervision.

Since supervision is particularly important in the first stages of market development, finding solutions to the discussed problems should not be postponed further but tackled as soon as possible.

4. Would integrating the insurance and securities supervisors be beneficial for Ukraine?

In Part 4.1 we move the general debate on benefits and drawbacks of integrated supervision as described in Part 2 into the Ukrainian context. In Part 4.2 we confront the plans of integration with the most pressing problems of Ukraine’s financial supervision as described in Part 3 and ask whether integration would help to improve the current situation.

4.1 Benefits and drawbacks of an integrated supervision in the Ukrainian context

Many countries in the European Union have merged their supervision authorities to enable financial conglomerate supervision and to ensure competitive neutrality. This has been the major driving force. As Ukraine’s financial sector so far does not show any substantial development of financial conglomerates, these benefits do not apply. Besides, even if financial conglomerates did exist, they would still not be supervised on a consolidated basis. After all, the merger proposal does not include banking sector supervision. For this reason, there is also little to be gained by regulatory flexibility through an integrated supervisor. Some advantage can be seen in an improvement of accountability, but - once again - as banking supervision remains outside of the merged authority, this advantage is limited. One remaining advantage may prove to be beneficial in the long-run. Some gains of efficiency can be expected. However, these economies of scale will not accrue in the short or medium term, as financial sector supervision in Ukraine is currently dramatically understaffed. Summing up the benefits, only very limited synergy gains can be realised in the long-run.

The drawbacks, however, will immediately be felt by policy makers and market participants alike. There is a high risk that the new authority will not be sure about its objectives in the first years. In addition, there is a substantial threat that a newly created supervisor of the insurance and capital markets will facilitate corruption. Firstly, the supervisor's staff may use the likely disarray of the change process to extract bribes. Secondly, a larger supervisor covering two sectors will find this easier, as one supervisor is easier to bribe than two.

Summing up, most benefits generally associated with an integrated supervisor will not materialise in Ukraine if the proposed merger is followed through. However, the risks involved are high.

4.2 The impact of integration on current problems of financial sector supervision

Besides these general considerations, the following will analyse the impact that a merger of the two commissions will have on those problems Ukraine's financial sector supervision faces today.

1) Lack of qualified employees

In Ukraine, „restructuring“ is often understood and implemented as a liquidation of former institutions and a complete build up of a new institution. In the case of the two commissions in question, a number of employees who have acquired substantial skills and experience in the past will leave the institution. Some will be fired, others, especially the most qualified employees, will leave the institutions voluntarily. As mentioned earlier, the supervisory authorities invest heavily into their staff. But as an integrated labour market exists, private financial institutions hire the authorities' staff once they are highly qualified. The risk is high that this problem will increase in the uncertainty of a merger process.

Result of integration (1): Negative.

It is very likely that this problem is one reason why the initial proposal to unify the financial supervision authorities only included the Financial Services Commission and the Securities Commission. Theoretically, a new unified supervisor might also be responsible for banking supervision. As Table 1 indicates, this has been a very common approach for supervision reform in other countries. But uniting all three authorities in Ukraine would have been even more problematic. As a rule, the employees of the National Bank of Ukraine, the current banking supervisor, have better working conditions and a higher status than those at a purely supervisory institution. The fear of loosing very capable employees to other institutions might have been high.

2) Lack of appropriate capital goods (especially software)

Most likely, an integrated supervisor would not bring about any changes to the better in this area. In contrast, in the short term some minor problems during the transformation phase (due to the harmonisation of systems, relocation, etc.) might prove difficult. As the timely and effective data collection and data processing is crucial for supervisors, the issue of adequate technological resources is to be considered of utmost importance for improving the supervision of the financial sector. But it is not relevant for the decision of the appropriate organisation of the sector's supervision.

Result of integration (2): Neutral.

3) Lack of political support and independency

In general, creating a larger and more important institution may increase this institutions political influence. This would – at first sight – suggest that unifying the Financial Services and the Securities Commission would lead to a higher degree of independence. However, vested interests of financial institutions in Parliament are very strong and it is questionable if a stronger, consolidated supervisor can change this situation. Thus, a noteworthy positive effect on this issue can not be expected from unification.

Result of integration (3): Neutral.

4) Continuous changing of the institutional framework

The two commissions have only recently been created (1995 and 2002). To improve and develop their full potential, institutions need time. As long as major organisational changes occur, the institutions will be busy with reorganising themselves and will bind resources needed to fulfil their actual purpose. This has prevented prudential supervision in the past. More reorganisation without enough time for the commissions to settle will worsen the state of financial sector supervision in Ukraine.

Result of integration (4): Negative.

Considering the impact of integration on the four major problems of Ukrainian supervision, one can expect a deterioration of two of these problems. A change to the better is not to be expected for any of these. The expected benefits generally associated with the integration of specialised financial sector supervision authorities will be too small to outweigh the significant negative effects.

5. Conclusions and recommendations

As described, financial sector supervision in Ukraine faces a number of significant problems. These problems seriously threaten the stability of the financial sector and impair financial intermediation in Ukraine, with consequences for economic development and social considerations. The planned integration of financial supervisors will not solve any of the major problems the Ukrainian supervisors face today. On the contrary, the situation is likely to worsen for an undefined period. In addition, the benefits generally attributed to integration are expected to be marginal in the case of Ukraine, as the proposed merger only includes the insurance sector and capital market supervision. Therefore, we recommend postponing unification of the supervision authorities until the existing supervision agencies have solved those problems that are currently most pressing.

Conclusion 1: Postpone integrating Ukraine's financial supervision in order not to worsen the situation.

In the short and medium term, the following more basic measures should be taken to improve prudential supervision:

- Improve working conditions including salaries to prevent skilled and experienced personnel to leave for financial institutions that require similar qualification
- Increase state funding and/or introduce partial funding through market participants[2]

[2] This is common in other European countries. For example, Germany's BaFin and the United Kingdom's FSA are fully funded through a levy on the firms they regulate, budget funds are not used at all. This enables the authority to pay higher salaries than other public sector authorities. Thus, the authority's ability to compete with private financial sector institutions on the job-market is improved.

- Improve technical infrastructure, especially through investments into software
- Facilitate the exchange of information between the supervisors (institutionalised regular meetings, sharing of harmonised information) to improve the ability to supervise financial conglomerates

Conclusion 2: Focus on the fundamental problems and improve supervision capacity.

Apart from improving the situation of the supervision authorities it is crucial to increase the transparency of Ukraine's financial sector. Currently, transparency is very limited and dramatically impairs effective financial sector supervision. A separate forthcoming advisory paper will address this crucial issue.

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